Each and everyday you risk your lives
And that makes you a hero
And that makes you a hero
And that makes you a hero in my eyes!

REGULATION OF DERIVATIVE PRODUCTS

HON. JAMES A. LEACH
OF IOWA
IN THE HOUSE OF REPRESENTATIVES
Friday, July 31, 1998

Mr. LEACH. Mr. Speaker, in the past fortnight, the Banking Committee has held two hearings on the regulation of over-the-counter markets in derivative and hybrid instruments. Bankers and businessmen, farmers and fund managers use these esoteric financial products, whose value derives from an underlying asset like a government bond or the income stream from a loan, to mitigate risk from changes in commodity prices or interest rates. Few Americans have ever come into contact with one of these instruments, but every American with a pension fund or money in a bank has been affected by them.

I scheduled the hearings in response to an unusual circumstance: three of the four government agencies which have responsibility for overseeing the derivatives market place—the Federal Reserve Board, the Treasury Department, the Securities and Exchange Commission—have come to the conclusion that the other principal regulator, the Commodity Future Trading Commission, has embarked on a regulatory path at odds with the U.S. national interest.

The Fed's, Treasury's and the SEC's concerns about a rogue regulator were touched off by a long and detailed request for public comment on OTC derivatives trading practices issued in May by the Commodity Futures Trading Commission. OTC derivatives have some characteristics of futures—like futures, they are used to manage risk—but the Congress has never defined them as such and, in 1992, directed the CFTC to exempt them from the Commodity Exchange Act, which the CFTC administers. Although the CFTC stated in its release that its questionnaire was merely a fact-finding exercise, to everyone else it had the potential of radically changing the existing laws and regulations with the unsettling prospect that existing contracts could be invalidated. To the market place, the CFTC inquiry had all the tell-tale signs of precipitating a regulatory regime that would cause a market currently dominated by American firms and under American law to go off shore.

The current laws and regulations that govern the trading on our futures exchanges and over-the-counter markets are a tissue of ambiguities and exceptions—a veritable elysian field for lawyers. It is not an exaggeration to say a unilateral CFTC change in the definition of a swap, which was clearly contemplated in its public comment request, could invalidate thousands of similar contracts held by banks and other financial institutions and businesses here and abroad, worth billions of dollars. Such a stroke would jolt the world's financial system and force our financial institutions to take this innovative and profitable business to a foreign location, whether it be London, Tokyo or the Caribbean.

For better or worse, the word ''paradigm'' has in recent years become one of Washington's most fashionable expressions. At the risk of contributing to its overuse, it would appear that the interagency dispute that has been revealed is reflective of two separate but overlapping paradigms, one stemming from perspectives grounded in a career in law, the other from careers rooted in finance and economics.

Chairman Born's paradigm, which involves a legalistic reading of the Commodity Exchange Act, has certain merit in the abstract. But in the real world of trading, a world shaped by history and legislative intent, world not frozen in footnotes, the economic paradigm should be considered the dominant one. Indeed, the extraordinarily original analysis Chairman Greenspan provided the Banking Committee last week amounts to an essay that should be required reading for every college economics student.

The Greenspan paradigm will not be found in any legal tome because it captures a dynamic and fast-evolving situation, whereas the legalistic Born paradigm, by its very nature, must look backward for precedent.

In brief, Chairman Greenspan argued that, as currently implemented, the Commodity Exchange Act was not an appropriate framework for professional trading of financial futures. The CEA, he noted, was enacted in 1936 primarily to curb price manipulation in grain markets and its objectives haven't changed since then. As a consequence, we are applying today crop-futures regulation to instruments for which it is wholly inappropriate. The Greenspan view is that the financial derivatives markets are encumbered with a regulatory structure devised for a wholly different economic process, a structure that impedes the efficiency of the market system and slows down improvement in living standards.

This is rich food for thought for Congress. The interagency regulatory Donnybrook is unseemly, generating market tension and uncertainty. It shows that our system may need a fix. If a single regulator can roil markets with an institutionally self-serving and whimsical reading of the law, it is time to have a good look not only at the statutes but at who enforces them.

The ''who'' and the ''what'' of regulation in this area must be revisited, with an understanding that it is more important for regulation to be adapted to markets than for markets to be hamstrung by regulation. A balance involving legal certitude, especially of contracts, must be established. This balance must be flexible enough to accommodate innovation, but also legally firm when it comes to issues like fraud.

Chairman Born's July 24 letter to Chairman Smith in which she states ''the Commodity Futures Trading Commission . . . will not propose or issue'' OTC derivative regulations until the Congress convenes in January 1999 momentarily muted the crisis. But, in effect, her offer isn't much of a concession. It is far short of the agreement Chairman Smith believed he had reached—and so said in a press release: ''the CFTC will not pursue regulation of over-the-counter (OTC) derivatives until Congress has the opportunity to act during CFTC reauthorization in 1999.''

It is my view that it would be preferable to resolve this dispute without legislation and, accordingly, I chaired two informal meetings with the regulators to attempt to reach an non-legislated solution. But given the impasse, I introduced H.R. 4062, which provides a standstill on new regulation until the CFTC reauthorization is done. Work on this bill has been temporarily suspended to give everyone time for another effort at compromise. But if the Agricultural Committees don't address the issue, the bill remains on the table for consideration yet this year.

Meanwhile, I am asking the Secretary of the Treasury, in his capacity of chairman of the President's Working Group on Financial Markets, to undertake a study of our regulations and regulators. The industry, academic experts, and other interested parties, including users of derivative products, should be given a prominent voice in the study. The Treasury Secretary should provide the Group's findings and suggestions to the appropriate committees in the House and Senate by February 1, 1999, so that the Congress can get an early start on rebuilding our market supervision system. Nothing less than the primacy of the U.S. financial industry in the world is at stake—along with the safety and soundness of our banks and protection of their customers.

DEPARTMENTS OF VETERANS AFFAIRS AND HOUSING AND URBAN DEVELOPMENT, AND INDEPENDENT AGENCIES APPROPRIATIONS ACT, 1999

SPEECH OF

HON. EDWARD J. MARKEY
OF MASSACHUSETTS
IN THE HOUSE OF REPRESENTATIVES
Wednesday, July 29, 1998

The House in Committee of the Whole House on the State of the Union had under consideration the bill (H.R. 4194) making appropriations for the Departments of Veterans Affairs and Housing and Urban Development, and for sundry independent agencies, boards, commissions, corporations, and offices for the fiscal year ending September 30, 1999, and for other purposes:

Mr. MARKEY. Mr. Speaker, I rise in strong support of the motion to recommit offered by the gentleman from Wisconsin [Mr. OBEY].

Under the version of the bill reported out of the Appropriations Committee, a legislative rider was attached which would prevent the CPSC from adopting a rule regarding flammability standards for upholstered furniture until an outside panel was convened to examine the toxicity of fire retardants that would be used to treat such furniture. Currently the CPSC is considering a flammability standard for upholstered furniture. They are doing so pursuant to a petition from the National Association of State Fire Marshals, who asked the CPSC more than four years ago to develop a mandatory safety standard for upholstered furniture to address the risk of fires started from open flames—such as lighters, matches, and candles. The Fire Marshals called for such a rule because the U.S. has one of the highest fire death rates in the world. Nearly 4,000 people died in 1995 because of fires that started in their homes, of which nearly 1,000 were children under the age of 15.

Over the last four years the CPSC has been going through the process of taking public comments, conducting laboratory tests, and evaluating all the technical and economic issues relating to adoption of a safety standard in this area, including requirements relating to use of flame resistant chemicals to treat